IT 07-0015-GIL 04/05/2007 CREDITS – FOREIGN TAX

General Information Letter: Computation of income double-taxed by Illinois and California explained.

April 5, 2007

Dear:

This is in response to your letter dated January 24, 2007, in which you request a review of the computation of the credit allowed to Mr. and Mrs. Z for taxes paid to California for 2005. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www. tax.illinois.gov.

In your letter you have stated the following:

> The taxpayers had a 2005 California real estate sale with a taxable gain of $105,277 resulting in $7,568 of California tax. Without this California income, the taxpayers would not have paid any Illinois tax, as most of their income was nontaxable IRA and pension distributions. Due to the legal department's unusual proration calculation, the taxpayer's state tax credit has been reduced, resulting in an Illinois tax of $1,744.
>
> The Illinois Department of Revenue Regulations Section 100.2197 discusses double taxed income and base income. Your department's computation is attempting to adjust California base income by the IRA and pension distributions, which are not taxable to either California or Illinois, and then limiting the double taxed income again by the same percentage. This formula has skewed the foreign tax credit and certainly is not equitable to the taxpayers. Ms. Y conceded there have been problems with the California formula.
>
> We respectfully request you review this case and restore the foreign tax credit as originally filed and refund the $510 overpayment as originally requested.

Response

Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601) provides, in part:

> The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. The aggregate credit provided under this paragraph shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year.

The Department's regulation at 86 Ill. Adm. Code Section 100.2197(b)(4) provides that, in order to compute the "base income subject to tax by both such other state or states and by this State" (referred to as "double-taxed income"), a taxpayer should take into account only those items of income taxed by both states and should deduct only those expenditures for which both states allow a deduction. Section 100.2197(b)(4)(G) provides:

> Some states compute the tax liability of a nonresident by first computing the tax on all income of the nonresident from whatever source derived, and then multiplying the resulting amount by a percentage equal to instate sources of income divided by total sources of income or by allowing a credit based on the percentage of total income from sources outside the state. Other states determine the tax base of a nonresident by computing the tax base as if the person were a resident and multiplying the result by the percentage equal to in-state sources of income divided by total sources of income. The use of either of these methods of computing tax does not mean that income from all sources is included in double-taxed income. See Comptroller of the Treasury v. Hickey, 114 Md. App. 388, 689 A.2d 1316 (1997); Chin v. Director, Division of Taxation, 14 N.J. Tax 304 (T.C. N.J. 1994). When a state uses either of these methods of computation, double-taxed income shall be the base income of the taxpayer from all sources subject to tax in that state, as computed in accordance with the rest of this subsection (b)(4), multiplied by the percentage of income from sources in that state, as computed under that state's law; provided, however, that no compensation paid in Illinois under IITA Section 304(a)(2)(B) shall be treated as income from sources in that state in computing such percentage.

Cal. Rev. & Tax Code Section 17041(b)(2) provides that the personal income tax of a nonresident:

> shall be calculated by multiplying the “taxable income of a nonresident or part–year resident,” as defined in subdivision (i), by a rate (expressed as a percentage) equal to the tax computed under subdivision (a) on the entire taxable income of the nonresident or part–year resident as if the nonresident or part–year resident were a resident of this state for the taxable year and as if the nonresident or part–year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

This formula is mathematically identical to the computational methods described in Section 100.2197(b)(3)(G), and credit for taxes paid by the Zs to California was computed accordingly. This computation reflects the manner in which California income tax is computed, which, unlike Illinois, treats the Zs' retirement income and IRA distributions as taxable. If those items were not treated as taxable income by California, the Zs' liability would have been less than half of the liability actually imposed.

The credit allowed to the Zs was computed in accordance with the regulation, and is correct.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual

situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax